DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15428
San Diego, Calif. 92115

36 Letters per Year—$60.00 Annually

Registered with the Securities Exchange Commission

January 5, 1968 Letter 380

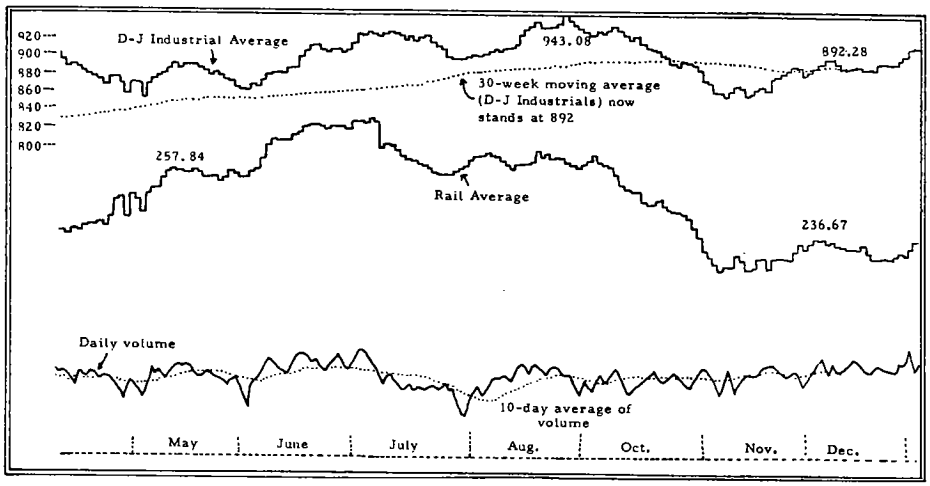
THE MARKET: In Letter 375 I outlined the important series of non-confirmations which have characterized the action of the Averages over the past five months. Referring to the chart on page 2, note the major non-confirmation during August, 1967, as the D-J Rail Average bettered its February 15 high by three points, a move which was unconfirmed by Industrials (Industrials failed by 53 points in bettering their February, 1967 high).

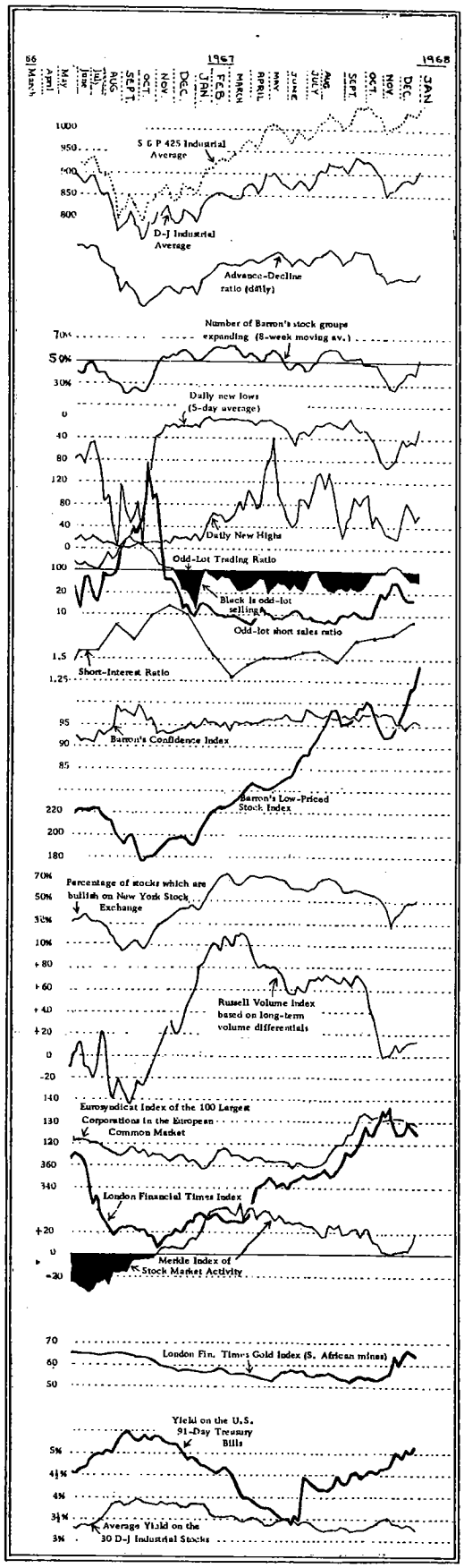
Now turning back to the daily chart on the bottom of page 1, we note that at the 1967 peak of 943.08 (August 25), the Industrials rose to a new 1967 recovery high—but this time it was the Rails which refused to confirm (Rails failed to better their earlier August peak).

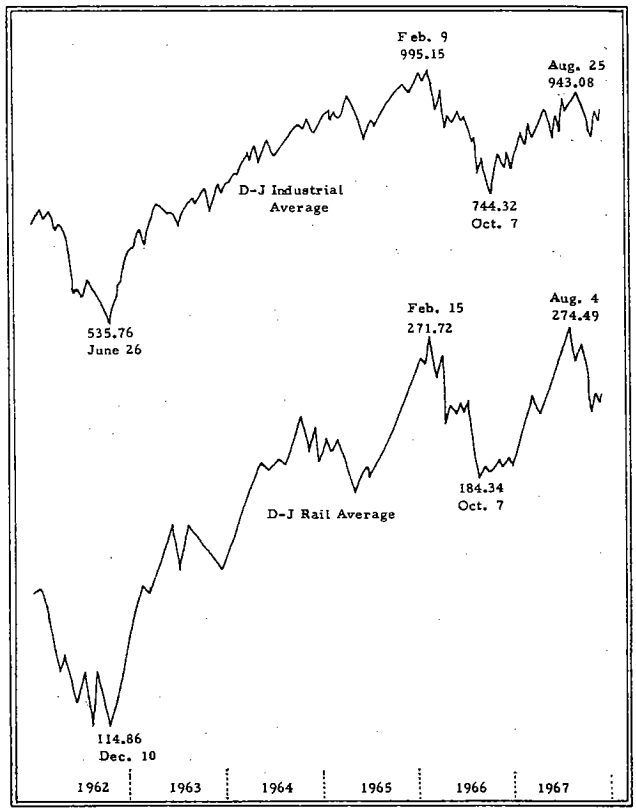
Thus we witnessed a second non-confirmation within the overall price structure. I wrote last week that I believed the Rails were pointing the way to the downside, and that during primary bear markets it was characteristic of Rails to remain the weaker Average.

Now, it seems, we are seeing a third non-confirmation. Again, turning to the daily page 1 chart it is apparent that the Rails are continuing their lackluster performance. In early December the two Averages recorded highs, Industrials 892.28 and Rails at 236.67. Following a two-week recession the market rallied again. On December 27 Industrials closed above their early-December 892.28 high, but Rails refused to confirm by a mere 23¢. In fact, the trend of the Rail Average all during December has been sideways to down.

Overall, since August 25 we have seen two distinct non-confirmations, one major and one intermediate and the latest of somewhat minor importance. Taken together I would say that the Averages are now importantly out-of-gear, and they are saying that dangerous times may lie ahead. If 1968 turns out to be a poor or even very bad year (and I suspect that it will), no one can blame the Averages for not issuing fair warning. I am particularly interested in this series of non-confirmations for two reasons: (1) the confirmation and non-confirmation concepts are such a fundamental part of Dow Theory, and (2) the series of non-confirmations since August 25 has received almost no publicity among investment advisors and advisory services. Referring to the latter, I always feel that important occurrences which no one comments upon thereby become doubly important. The corollary to this is probably that important phenomena that everyone comments on are greatly diminished in importance. In the latter category, I would now probably list the latest 20 million share short interest on the N.Y.S.E.




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Block is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks



Next month (February) will mark two years since the two D-J Averages recorded their last confirmed (primary) highs. That marked the top of the 1949-1966 bull market. Yet it is rather incredible that now, two years later the market (which I believe is a primary bear market) has not shown greater weakness. The explanation for the lack of major weakness is twofold, in my opinion. First, the public has been conditioned by 17 years of bullish stock action to expect that all tops will eventually be bettered. This occurred after the 1953 peaks, the 1956 and '57 peaks, the 1960 highs, the 1961 highs and again in 1965.

There are few who believe that the 1966 (February 9) Dow peak of 995.15 will not be bettered over the foreseeable future. True the February 15, 1966 Rail high of 271.72 was bettered by a few points in August, 1967, but this constituted the major non-confirmation which I have discussed in detail. The fact remains that Industrials are still well below their 1966 high, and the Rails are now well below their 1966 and 1967 highs.

The second reason for the lack of important downside action despite a bear market which is now almost two years old is the major import of Government manipulation. The Government and the politicians who run our Government are determined to hold onto their elected offices, and to do this they must "make people happy". Therefore, they will go to any extremes to keep "prosperity" in the saddle. One of the most successful (but short-sighted) methods of insuring this illusion of perpetual prosperity is via inflation. Inflation is usually bullish or at least it breeds optimism— up to a point. But ultimately, all periods of inflation terminate when first the informed few, then the public, start to distrust the "values" upon which inflation is built.

In 1962 we saw a psychological phenomenon wherein a sudden mass distrust of "new issues' descended upon Wall Street. In a period of a few months, many unseasoned stocks which had skyrocketed completely collapsed, most never to return to their former inflated glory. No one could really explain the sweeping period of disillusionment. It just happened, as it had always happened before. A few weeks ago veteran analyst Anthony Gaubis wrote, "....market history shows that whenever the primary emphasis in buying recommendations shifts to 'inflation protection,' it is a good time to sell rather than buy equities." Overall, I agree thoroughly with Mr. Gaubis. It is simply a matter of timing the fall.

Inflation talk is in the air now as it has not been in decades. The Government is dedicated to it, but at the same time I feel that there is an increasingly large portion of the population which is beginning to give serious consideration to the pitfalls and problems of inflation. They know that at a record negative yield spread (last week) of 3.12% in favor of high-grade bonds over stocks, something is out of kilter with the current concept of values. They know that high-grade bonds should not yield twice average stock yields, and that such situations, while extraordinary, never last. These are the people who have been distributing stocks ever since the February, 1966 top. They will continue to distribute on balance until a major decline has once again rendered stocks attractive, in their opinion.

The bull market which began in 1949 lasted 17 years, twice the duration of the 1921-29 bull market. It is probably normal that we now see an extended, drawn-out top lasting two years or more. Nevertheless, whether the bull-bear cycle is three years, ten years or twenty years, I believe our investment procedure should be the same. This calls for an aggressive invested position throughout most of a bull market and a largely cash position throughout most of a bear market— regardless of the size or the formation of the final top.

During 1968 I expect to see the bear market develop in a more true-to-form manner. I expect to see the dislocations and problems of 1967 (Which have not yet been resolved) grow to major proportions. It is becoming more and more difficult to tuck our problems under the bull market rug. The rug itself is growing tattered.

SHORT INTEREST: In December the Exchange released the latest short interest figures, which showed a 2.6 million rise bringing the short interest total on the N.Y.S.E. to 20.9 million, highest in history. What does this mean?

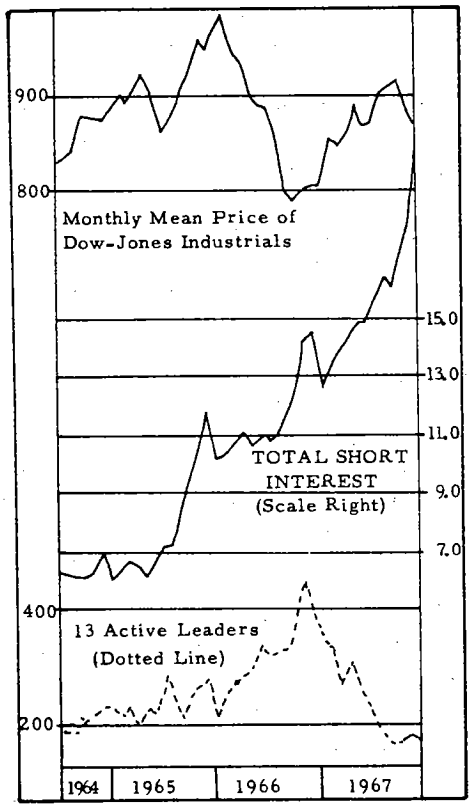
Well, first of all let me say that I feel I am well qualified to answer this question. I wrote the first article to appear in Barron's on the short interest. It was entitled "Tell-Tale Ratio" and appeared on December 28, 1959. That article was written when few market followers knew much about the short interest, and the short interest ratio was a complete mystery.

First of all, there is a built-in bias towards a higher short interest due to more and more traders, higher volume and more listed issues. But this is far outweighed by the massive amount of issues now under arbitrage due to mergers and hedge shorts. As Indicator Digest stated in its latest report, of the 10 largest short positions for November, 8 were affected by arbitrage.

In fact, so great is the current arbitrage position that the Digest has decided to run the monthly short interest ratio on just the 30 Dow stocks. These stocks are considered too large for most mergers, and thus the chance of arbitrage is slim. At present, it is well to note that the short position in the 30 Dow stocks has dropped from the 1966 high of 1.3 million to a recent low of 700 thousand. Furthermore, it was seen that the short interest in the Dow stocks ranges from about .7 to about 3.6. At present it is at 1.0, which is rather bearish. A long-range chart of the short interest ratio in the Dow stocks shows that the ratio is far more accurate for the market when based on the Dow stocks than when based (in the accepted way) on the total N.Y.S.E. short position.

Tending to agree with the Digest studies are the studies of Garfield Drew (Drew Odd Lots). For four years Drew has been issuing monthly short interest totals of 13 active leaders on the N.Y.S.E. Drew was one of the first to note the invasion of the merger boys with the consequent steady rise in arbitrage shorts.

With thanks to Mr. Drew, I have reproduced his short interest chart on this page. Note that since 1966 the short interest in the 13 active leaders (such stocks as U.S. Steel and General Motors) has dropped from a high of over 400 thousand to a 1967 low of under 200 thousand. This checks out rather closely with the Indicator Digest study of the short interest in the 30 Dow Stocks.



CONCLUSION: (1) As I have stated many times before, a large short interest during a primary bear market is not the bullish prop that it is when the short interest builds up during a bull market. During a primary bear market, the shorters are "invested" with the trend. (2) Due to the steady rise in mergers and consequent arbitrage shorts, the short interest has had an upward bias since the early 1940's. This bias has intensified during the 1960's. I consider either the Drew studies of 13 active leaders or the Indicator Digest studies of the short interest in the Dow stocks to be the ones to watch now. Subscribers will be kept abreast of these two studies from here on.

GOLD: About the only fundamentally bearish possibility for the future of gold would be a termination of the Vietnam war. But in Asia, rather than a brightening of the outlook, there appears to be a distinct and disheartening expansion of the war. With the exit of McNamara, the U.S. is liable to assume a more hawk-like attitude with the Pentagon's "let's clean up the war in a hurry" policy probably taking over. Meanwhile, news of the spread of the war into Thailand, Cambodia and Laos is now out in the open. On December 26 Premier Souvanna Phouma of Laos announced that a "general offensive" was underway against Laotian position in the southern tip of that country. Thus, the war and the expenses of the war show no signs of abatement.

A more positively bullish aspect of the gold picture is that the U.S. continues to play directly into the hands of the man who insists that the world return to the gold standard, President Charles DeGaulle of France. DeGaulle's chief economic advisor has gone on record many times to the effect that either the world will go into the gold standard or the gold standard will be forced on the world. The gold-exchange standard, insists Rueff, in which dollars and pounds (the reserve currencies) are counted "as good as gold" among the central banks of the world, is not working. The plain fact is that dollars and pounds are subject to the inflationary whims of politicians. They are depreciating currencies, states Rueff, and just as the pound has fallen, so (despite all the pious words of the politicians) will the dollar fall.

Economist writer Eliot Janeway was first to state that the French Government is now passing the word to gold hedgers and speculators. If the purchases of the gold hoarders fails to shake the dollar, then France will bail the hoarders and speculators out. It will bail them out by deliberately devaluing the franc, thereby largely negating the advantage of the British devaluation. Within days of a French devaluation, all the nations of the Free World would be forced to devalue, thus leaving the U.S. alone with no choice but to get in line.

A second less likely but still possible choice is left open to France. That is (and this was touched upon in the last Letter) a redirection of South African gold away from London and towards Paris. This is not completely far-fetched, for S. Africa is now smarting from the turn-down of her request for arms from Britain, and France is the one to which S. Africa must turn to now. Remember, the U.S. does not produce enough $35 gold to supply even the commercial and jewelry trade in this country (gold detractors, please notice), and S. Africa remains the single major supplier of gold to the Free World. What

 if S. Africa were to market all her gold in Paris? And what if Paris announced that the new floor for gold was $70 or $100 per ounce? If this occurred, there would be such an avalanche of buyers to take in U.S. gold at $35 per ounce that the U.S. Treasury stock would be badly depleted within a month.

So as I see it, the "have's" in gold are moving into position where they will shortly be "calling the tune" in gold. DeGaulle would rather have the speculators, hedgers and hoarders do his work for him or force a conference on a rise in the price of gold. But should the speculators fall short of the mark, his next move will probably come in Spring, 1968.

THE FEDERAL RESERVE has finally taken note of our vanishing gold supply and the displeasure which the rest of the Free World is showing towards our inflationary policies. "If the dollar is as good as gold," asks our creditors, "then how is it that there are more and more dollars available in the world and less and less gold?" If any of my subscribers can answer this one, please drop me a line.

At any rate Free Reserves in the banking system dropped to $47 million two weeks ago, although they rose to $100 million last week (the latter is still well below the recent average). This means a break from the easy money policy which has been in effect since late-1966. On December 27 the Fed raised by 1/2% the percentage of reserves Reserve banks and "country" banks must keep behind deposits. The amount of the reserve increase amounted to about $550 million. As has happened so often before, the money market and the stock market had discounted the latest Fed moves. After all, everyone knows that sooner or later the Fed must move, and it is usually later than sooner. Now if the dollar is devalued or if their is a run on gold the Fed can claim that back in 1967 "it did something," and that is what is important.

PRESIDENT JOHNSON opened the New Year with "feeler" proposals to help our balance-of-payments. Among the promised (or threatened) tidbits are a limiting of corporate spending overseas, limiting foreign travel for Americans and putting new restrictions on foreign borrowing in the U.S. But already the repercussions have started. Britain states that the new U.S. proposals could wreck British business. On Friday, the yield on 91-day U.S. Treasury bills jumped to 5.08%. If U.S. money is cut off from Europe (as LBJ threatens) we can expect interest rates there to go through the roof overseas. Since money and interest rates do not exist in a vacuum, it is sure that a new climb in European interest rates would send interest rates sharply higher here. Perhaps that is what the 91-day Treasury bills were "saying" last week when they went over 5%.

QUOTE OF THE WEEK: →

From the Christian Science Monitor (Dec. 29): "The President, addressing American troops at Cam Ranh Bay, alluded to the bleak prospect for peace when he said rather wistfully: 'I wish I could have brought you, too, some sign that the struggle will soon be over— some indication from the other side that he might be willing to let this suffering land heal its wounds.' "

ANNOUNCEMENT: My friend Dan Merkle has just published an excellent new book entitled Relative Strength and Stock Market Timing. Dan (head of Traders Research) has spoken to me about this book for the past few years, and I was most pleased when my copy arrived this week. The book is small (130 pages), hardcover bound, and printed on gloss paper. It is generously sprinkled with dozens of illustrative charts from Dan's excellent charting service.

The book is divided into two parts, (1) Relative Strength and (2) Stock Market Timing. The Merkle Index (which is carried on page 1 of Dow Theory Letters) is explained and its components analyzed. The first part of this book contains a thorough dissertation on relative strength and its application in both individual stocks and stock groups. In fact, it is by far the best explanation of relative strength that I have ever seen in print.

I am going to carry this book, and it is the first new book I have added to our book list in over a year. The price is $12.00, and we now have immediate delivery. I recommend the new Merkle book to all market students, investors and traders. It is the best book I have seen on relative strength, and I believe that a thorough knowledge of relative strength is essential to every investor and speculator.

If you would like a copy of the new Merkle book, please send us a check for $12 and please make check payable to Richard Russell Associates.

LATE NOTES: Latest rumors from Hanoi regarding negotiations somehow seem more "real" than before. Hanoi now claims it is ready to negotiate as soon as we stop bombing the north whether this is propaganda or not remains to be seen, but I rather doubt that it is.

On January 3 the U.S. Treasury announced a loss of $450 million in gold following the month ago loss of $475 million. This brings the total gold loss in the wake of the pound devaluation to $925 million, and it takes the total U.S. gold supply under the $12 billion level to $11.9 billion.